For release on delivery
Wednesday, October 24, 1973
10:30 a.m. M.S.T. (1:30 p.m. E.D.T.)

LESSONS FROM CREDIT RESTRAINT

Remarks by

Robert C. Holland

Member, Board of Governors
of the Federal Reserve System

before the

59th Annual Fall Conference of

The Robert Morris Associates

Phoenix, Arizona

October 24, 1973

I am very glad to be here and to be a part of your conference. I say so partly because, as a Robert Morris alumnus myself, it is pleasant to be back rubbing elbows with lending officers and hearing stories of the latest additions to the legends of fabulous loans. I am glad, too, to be able to pay my respects to your outgoing President, who has been a close personal friend of mine since the days he and I first began to learn about such things as the prime rate.

But I am also glad to join you in discussion for another reason. All of us here have been living through another episode of painful credit restraint, and it behooves us to help each other learn the most we can from that experience. Indeed, this has not been "just another" period of tight money. It has had its own peculiarities and distinctions, the most obvious of which is that it generated historic highs in most interest rates, pushing them to levels that would have been unthinkable only a few years ago.

In recent weeks, of course, some rates have moved back down somewhat. I believe a person would be both rash and premature, however, to regard that movement as a sure harbinger of a swelling flood of easy credit to follow. What can be concluded, I think, is that we are far enough through the current interlude of credit restraint to draw some instructive lessons from its course.

Why did interest rates climb so high? Three fundamental forces seem to have been at work. First and foremost, we have an extraordinarily strong inflation on our hands. It expanded credit demands markedly, and its erosion of the value of the dollar led borrowers, savers, and investors alike to add an inflationary premium to the interest rates at which they were willing to do business. The stronger the inflationary outlook, the bigger that premium became, and the higher interest rates escalated.

Second, in the struggle of governmental policies to hold down that inflation, a disproportionate share of the burden has been left to monetary policy. Fiscal policy, instead of reining in demands in timely fashion, in fact produced inflation-fueling deficits during the formative stages of the boom. Price and wage controls, while slowing up some of the symptomatic wage-price spiral, have done little to correct the causative excesses of demands over supplies, and sometimes these controls have been downright counterproductive in their side effects. In the end, the bulk of the task of squeezing out excess demand has once again been left to monetary restraint. Given one of the biggest peacetime inflationary excesses in our history, it should be no wonder that the countering credit restraint has had to go to extreme lengths.

But there has been a third force pervasively at work increasing the size of interest rate swings. This is the tendency for a growing share of credit restraint to be achieved via price deterrents - higher interest rates - with a decreasing share being effectuated by nonprice restraints on credit availability - e.g., rationing, loan ceilings and the like. Partly this reflects enhanced governmental efforts to cushion sectors hardest hit by credit restraint - particularly housing - by borrowing in the central money markets and channeling the funds directly or indirectly to users. Partly this reflects a continuing secular improvement in private institutions and marketing practices, freeing up old financial bottlenecks and inhibiting conventions and increasing the general fluidity of supplies of and demands for credit.

Finally, this rate behavior also reflects a deliberate change of policy emphasis by the Federal Reserve. In the previous cycle of tight money, the Fed supplemented its general monetary restraint by various devices to hold down bank credit availability directly - most importantly, by holding interest rate ceilings on big CD's well below the rates on competing market instruments. Circumventions of that approach developed quickly, both inside the banking system and outside. This time the Federal Reserve suspended rate ceilings on big CD's entirely, and adjusted upward ceilings on consumer-size time and savings deposits. These actions were designed to enable institutions to better compete with the marketplace for funds, within the limits of their earning capacity and to the extent called for in their own business judgment. Thereafter, when big CD's seemed to bulge large this spring and summer, financing an unduly sharp loan expansion, the Federal Reserve dealt with this development not by reimposing relatively low rate ceilings, but by introducing higher reserve requirements on increases in large CD's, thereby absorbing reserves and increasing the internal cost of funds to banks. This was market-type deterrence, and I think it worked reasonably well. To be sure, the course of events this time has not been entirely smooth--witness the bumpy experience with the 4-year time certificate--but on balance the contrast with other recent periods of restraint - both here and abroad - is a marked one.

I regard this tendency toward a greater dependence upon price as against nonprice rationing in credit restraint to be desirable on balance. It seems to me to hold the promise of working both more fairly and more efficiently over the long run - and this should apply whether you are monetarist or nonmonetarist in your monetary theory. But whether or not you agree it is desirable, I would argue that it is inevitable: the evolution of market forces is in this direction, powered by attractive incentives generated by our essentially private enterprise system. Like it or not, I believe you and I have to adapt to this trend.

If it is true that we face a future with relatively large interest rate fluctuations, you may be tempted to ask, "How high will interest rates go?" There is a brief and simple answer - high enough to make some borrowers flinch. To perform their stabilizing function in time of inflation, interest rates will need to go high enough so that some borrowers are led to defer spending in order to avoid paying those rates. It could be that the interest burden will exceed their capacity to pay; it could be that the high rates will simply irritate them beyond their point of tolerance, or it could be that rates will seem so high relative to where they might fall within a few months that it will prove a good business gamble to wait. Whatever the reasons, some discouragement of borrowing is necessary.

What are the implications of all this for bank lending policies? I would not presume to give you a definitive list, but several logical consequences seem quite clear to me. For one thing, banks and other lending institutions can best transmit such monetary restraint by avoiding arrangements with customers which insulate them from higher costs on new borrowings in times of tight money. This is particularly true with respect to cyclical borrowers - those whose credit demands bulge most in a boom - and prominent among these are a variety of larger businesses.

We must tread cautiously here in discussing lending rates, in order not to run afoul of the anti-trust statutes or the Committee on Interest and Dividends. But I want to point out to you that when the Committee came up with its so-called "dual prime rate" concept, it was effectively furthering the principle I have just referred to, insofar as that could be done within the constraints of a broad-scale program of wage and price controls. Under that concept, the large-business prime rate was allowed to evolve toward a rate floating up and down with short-term money market rates - and the preponderance of larger cyclical borrowers from banks seem to be covered by that loan pricing policy.

Looking back on this experience, I believe a fair observer would have to say that the "dual prime rate" approach has worked reasonably well, as controls go. If so, an important reason is that it was in good part simply an extension and formalization of a pricing tendency already extant within the banking community - namely, distinguishing between big national and smaller local business customers in adjusting lending rate charges. Some of the members of your organization helped the Committee on Interest and Dividends to a better understanding of this fact, and I think your customers, your shareholders, and your communities are better off as a result.

Another lending policy that deserves review is that with respect to bank loan commitments. Banks making commitments are promising assured future availability of funds to their customers, and recent developments are suggesting changes in both the range of costs which banks might face in bidding for the promised funds and in their ability to garner them. The flat banker statement that, "We'll pay whatever it takes to raise the money to cover our commitments," has a ringing sound, but it can betoken a simplistic policy that is very expensive both for the bank and for the community at large. To encourage more careful bank planning for how big a volume of commitments to make and how to balance bank resources and cost-carrying ability accordingly, all three of the Federal bank supervisory authorities last spring directed letters on this subject to large banks under their jurisdiction, and asked their examiners to check the commitment policies of each bank they go into.

A corollary commitment practice worthy of further scrutiny is its pricing. Commitment fees can be thought of as a kind of insurance premium charged borrowers who are thus insured access to bank funds. But to the outsider, commitment fee-setting appears dominated more by convention than by careful cost-benefit analysis. In particular, those fees do not appear adjustable to compensate for the risks of sharply higher bank costs that flow from the kind of cyclical fluctuations in money market interest rates and line take-downs that we have been experiencing recently.

The kind of credit squeeze we have been living through always creates incentives for banks to find ways to lighten or avoid some of the pressures on them. Sometimes this produces banking innovations that are useful and sound, and that become a part of ongoing banking behavior. But occasionally there emerge not-so-sound devices, whose advantages to either the bank or the borrower are short-lived--or even illusory--and which are antagonistic to the long-run interest of banking and the public at large.

There is one practice developing around the country these days that I am afraid belongs in this latter category. I refer to banks issuing letters of credit to businesses that use them to support their own notes sold in the market to raise money either for long-term investment or for general short-term working capital. These are sometimes sold under the label of "documented discount notes." So used, these letters of credit function virtually as a guaranty, and therefore they are of questionable legality in some jurisdictions. Apart from their legal status, such letters of credit are oftentimes not backed by adequate credit analysis nor constrained by either regulatory or management limits of the type applied to conventional loans. When that happens, they impose credit and liquidity risks upon the bank that - if realized - can be very disproportionate to the bank's willingness and ability to bear them.

Furthermore, this kind of use of letters of credit is subversive of monetary policy, since it conveys the equivalent of bank credit outside the present scope of reserve requirements and other deposit regulations, yet in a form that is cushioned by the bank's name from the full rigors of competition in the open market for funds. All told, this type of use of letters of credit - much different in safety and in purpose from the typical letter of credit - strikes me as being potentially unsound and contrary to the purposes of monetary policy. Bank supervisory authorities are concerned with this development, and if bank managements themselves cannot deal with the undesirable aspects of this credit use, the supervisors may have to do so.

Much of this speech has dwelt upon the effects of interest rates fluctuating upward to relatively high levels. That is simple realism; we are currently in such a high-interest-rate phase. But if we are able to lick this stubborn problem of inflation, the other influences I mentioned should work just as well to make interest rates fluctuate downward for significant spans of time.

Moreover, this environment of sharply fluctuating interest rates is not necessarily any bonanza for bank profits. Increasing gross revenues from more loans at higher rates can easily be offset by investment portfolio losses and increased payments to attract and hold time and savings deposits. Indeed, how best to manage the raising of bank funds under circumstances of widely varying interest rates can be the subject of conferences in its own right.

Insofar as bank lending policies are concerned, let me conclude by pointing out that monetary policy depends upon them to spread its effects efficiently and fairly among bank customers. How far monetary policy can go, and how successful it can be in serving its varied objectives, rests in important degree on what transpires across the desks of your lending officers. I hope that they and we all can draw the kind of object lessons from our latest experiences that will help us to make our next round of banking decisions better than ever.